United States Senate

Republican Policy Committee

Jon Kyl, Chairman

Lawrence Willcox, Staff Director
347 Russell Senate Office Building
Washington, DC 20510
202-224-2946
http://rpc.senate.gov

May 4, 2005

Time to End Social Security Trust Fund Double-Counting

History Makes the Case for Personal Accounts

- This paper reviews Social Security's history to demonstrate that Social Security surpluses can be saved only if an ownership right is assigned to them. Congress should create personal retirement accounts as a part of Social Security modernization to grant individual workers this ownership right and build real savings.
- Under the current unified budget, annual Social Security payroll tax revenue in excess of annual Social Security outlays is effectively double-counted: on the one hand, the surplus is spent to fund current government outlays on programs like food stamps, agricultural price supports, federal student loans, and child nutrition; on the other hand, the surplus is *credited* to a Treasury account, known as the Social Security Trust Fund, where it will earn interest.
- Although the practice of "double-counting" Social Security surpluses has existed since the 1930s, this was of less consequence in the past because the program was funded on a pay-as-you-go (PAYGO) basis, which meant that the Trust Fund balance (and unfunded liability it represents) would remain small.
- This ended with passage of the Social Security Act Amendments of 1983, which led to the build up of a Trust Fund balance that will grow to a level *nearly eight times larger*, as a share of the economy, than its average during the PAYGO era (1940-1983).
- Since 1984, the Social Security Trust Fund account has been credited with $1.7 trillion – despite the fact that those funds have already been spent on other programs. In other words, there is no money in the Trust Fund – only a promise that General Fund revenues will be used to pay Social Security benefits when payroll taxes are insufficient by themselves.
- Because the surpluses were not saved, but were spent instead, the most recent estimates suggest that it will ultimately cost the General Fund $5.4 trillion (in constant 2005 dollars) to reimburse Social Security for all of the money Congress is scheduled to spend. Instead of continuing on the current path, Congress must embrace *real* pre-funding through the creation of personal retirement accounts. Personal accounts are the only means to convert Social Security financing from the curse of compounding debt to the blessing of compounding wealth.

Introduction

Under the current unified budget, annual Social Security payroll tax revenue in excess of annual Social Security outlays is effectively double-counted. On the one hand, the surplus is spent to fund current government outlays on programs like food stamps, agricultural price supports, federal student loans, and child nutrition.[1] On the other hand, the surplus is *credited* to a Treasury account, known as the Social Security Trust Fund, where it will earn interest.[2] Since 1984, the Social Security Trust Fund account has been credited with $1.7 trillion – despite the fact that those funds have already been spent on other programs.[3] In other words, there is no money in the Trust Fund – only a promise that General Fund revenues will be used to pay Social Security benefits when payroll taxes are insufficient by themselves.

Of course, if a dollar of tax revenue is used to fund current spending, it cannot be saved. Conversely, if that dollar is saved to fund an obligation due sometime in the future, it cannot be spent today. This simple arithmetic fact – so easily overlooked when discussing obscure concepts like rates-of-return, Trust Fund solvency, and actuarial balance – is the basis of the case for personal accounts.

As the 2005 Social Security Trustees report makes clear, the revenue generated by Social Security payroll taxes will be insufficient to cover scheduled benefit levels in only 12 years, and the difference between payroll tax revenues and promised benefits will grow each year thereafter.[4] Since the funds intended to be saved in the Trust Fund instead have been spent on other federal programs, the Treasury is grossly unprepared to finance this eventuality. Devoid of assets purchased with real cash, the Trust Fund is useful *only as a tally* of the amount of general revenue that must be transferred to meet Social Security obligations during the period between 2017, when deficits will begin, and 2041, when the Trust Fund balance is expected to reach zero.[5] Rather than being a store of wealth, it is more akin to a credit card statement showing how much has been borrowed from Social Security.

Background on the "Trust Fund"

The Social Security Act became law in 1935, but its implementation was staggered: Social Security payroll taxes were to be collected starting in 1937,[6] and benefit payments were

---

[1] These programs were selected for illustration because combined spending on this programs in 2005 ($76 billion) is roughly equivalent to the projected Social Security cash surplus for this year ($80 billion). "Current Budget Projections," Congressional Budget Office, March 2005.

[2] The Social Security Act authorizes the issuance of special public-debt obligations for purchase exclusively by the trust funds. The Act provides that the interest rate on new special obligations will be the average market yield, as of the last business day of a month, on all of the outstanding marketable U.S. obligations that are due or callable more than 4 years in the future. The rate so calculated is rounded to the nearest one-eighth of one percent and applies to new issues in the following month. Beginning January 1999, in calculating the average market yield rate for this purpose, the Treasury incorporates the yield to the call date when a callable bond's market price is above par. "2005 OASDI Trustees Report, VI.A.

[3] Social Security Trust Fund Data, Social Security Administration, January 29, 2005.

[4] 2005 OASDI Trustees Report, II.A.

[5] 2005 OASDI Trustees Report, II.A.

[6] 1935 Social Security Act, Section 801.

not to begin until 1942.[7] Since payroll tax collections in 1937 and 1938 were used to finance general government outlays, the public sensed that these "social insurance contributions" were really just new taxes wholly unrelated to the new benefit program. These tax receipts were accounted for in a "reserve fund," but, as Republican Presidential nominee Alfred Landon quipped in 1936, "the fund will contain nothing but the government's promise to pay."[8]

To combat this criticism, the Social Security Board and the Senate Finance Committee chartered an advisory board in 1938 to bolster support for the new program.[9] Congress incorporated most of the recommendations contained in the board's final report in the Social Security Act Amendments of 1939, which accelerated the date of benefit payments to January 1, 1940, and established a new separate account in the Treasury known as the Old-Age and Survivors Insurance (Social Security) Trust Fund.[10]

Trust Fund Designed to Confront a Political, Rather than Economic, Problem

It is clear from both its structure and origin that the Social Security Trust Fund was created to address a political, rather than economic, problem. Instead of being used to purchase real assets, surplus payroll tax revenues were to be loaned to the General Fund of the Treasury in exchange for interest-bearing, special-obligation bonds guaranteed by the full-faith-and-credit of the United States.[11] The Trust Fund, like the reserve fund that preceded it, would contain nothing but the government's "promise to pay." However, those promises would now take the form of "investments" in interest-bearing securities backed by the full faith and credit of the United States.

According to President Roosevelt, the issuance of Treasury bonds to the Trust Fund was intended to "give the contributors a legal, moral, and political right to collect their pensions and their unemployment benefits."[12] Since Social Security taxes flowed into the same depository accounts across the country as the rest of the government's operating cash pool, Roosevelt feared that opponents of Social Security could erode support for the program by pointing to the disconnect between its outlays and revenues.[13] The Trust Fund account was aimed at weakening this line of argument by ensuring that every dollar "borrowed" to finance unrelated spending would be paid back to Social Security with interest. Social Security Board Chairman Arthur Altmeyer stated that the purpose of the Trust Fund was "to allay the unwarranted fears of some people who thought Uncle Sam was embezzling the money."[14]

As many officials recognized at the time, unless the surplus payroll taxes were somehow insulated from the rest of operating cash pool, the Trust Fund balance would represent an unfunded liability of the government. Although considerable opposition had been expressed to

---

[7] 1935 Social Security Act, Section 202.
[8] "A Question of Numbers," *The New York Times*, January 16, 2005.
[9] For background on the Council and a copy of its report, see: http://www.ssa.gov/history/reports/38advisegen.html
[10] 2005 OASDI Trustees Report, VI.A.
[11] Social Security Act Amendments of 1939, Title II.
[12] Roosevelt quoted in Arthur Schlesinger Jr., *The Coming of the New Deal*, Houghton Mifflin Company, Boston, 1959, p. 309.
[13] Schlesinger.
[14] U.S. Senate, Committee on Finance, *Social Security Act Amendments: Hearings before the Senate Finance Committee on H.R. 6635*, 76th Congress, 1st session, 1939.

simply investing surpluses in government bonds, no other form of investment received positive support.[15]

Private investment was rejected because of concerns that government (politicized) investment would compromise the economy's allocative efficiency. More importantly, officials reasoned that since the program would be financed on a pay-as-you-go (PAYGO) basis going forward, the taxes assessed on workers would be roughly equal to the outlays paid to beneficiaries, and so the Trust Fund balance would remain small. This understanding is reflected by the fact that the 1939 Amendments included language instructing the Managing Trustee to immediately inform Congress if the Trust Fund balance had grown *too large*.[16]

Ad Hoc Adjustments and the Trust Fund

The 1939 Amendments contained no automatic mechanism for increasing Social Security benefits to keep pace with inflation or the growth of wages in the economy. For the next three decades, increases in benefit levels were enacted on an ad hoc basis.[17] Some of the benefit increases were quite large (the 1950 Amendments increased benefits across the board by 77 percent), while others (1958 and 1965) were more modest.[18] But all were accompanied by tax increases roughly approximate to that required to finance the benefit increase.

This led the income base subject to the payroll tax to triple from $3,000 in 1940 to $9,000 in 1971, while the combined Social Security payroll tax rate more than quadrupled, from 2.0 percent to 9.2 percent over the same period.[19] As the tax increases preserved Social Security's PAYGO structure, the Trust Fund "balance" stayed roughly constant as a share of the economy (Gross Domestic Product). The balance in the Trust Fund account averaged 3.7 percent of GDP during this period, with a record high of 5.4 percent of GDP in 1954 and a record low of just under 3 percent of GDP in the late 1960s.[20]

Unified Budget and Formulaic Increases Transform Social Security

As the escalating costs of the Vietnam War and domestic spending initiatives ballooned the General Fund's deficit, President Lyndon Johnson consolidated all Treasury accounts into a single, unified budget in 1969.[21] A Presidential Commission recommended that he do so in

---

[15] Robert J. Myers, "Actuarial Aspects of Financing Old-Age and Survivors Insurance," *Social Security Bulletin,* June 1953.

[16] "It is the duty of the Board of Trustees to report *immediately* to Congress whenever the Board of Trustees is of the opinion that during the ensuing five fiscal years the Trust Fund will exceed three times the highest annual expenditures anticipated during that five-fiscal-year-period." Social Security Act Amendments of 1939, Title II. "Presumably, the tax schedule might be modified in the future by Congress if the Trust Fund should become so large that it would be in conflict with what was apparent the [PAYGO] financing philosophy of the 1939 legislation." Myers.

[17] Geoffrey Kollmann, "Social Security: Summary of Major Changes in the Cash Benefits Program," CRS Report for Congress RL30565, May 18, 2000.

[18] Kollmann.

[19] "History of the Provisions of Old-Age, Survivors, and Disability Insurance," Social Security Administration. Available at: http://www.ssa.gov/OACT/HOP/hopi.htm.

[20] 2005 OASDI Trustees Report.

[21] David Stuart Koitz, "Social Security and the Federal Budget: What Does Social Security's Being 'Off Budget' Mean?" CRS Report for Congress 98-422, August 29, 2001.

order to give the credit markets a more complete view of the government's cash flow and borrowing needs.[22] Congress adopted the unified budget for its own calculations through passage of the Congressional Budget and Impoundment Control Act of 1974 (P.L. 93-344). From this point forward, the unified budget's surplus or deficit would become the main barometer of the nation's fiscal position, lessening the significance of the balance in the Trust Fund account.[23]

At roughly the same time, Congress elected to end the practice of making ad hoc adjustments to Social Security by establishing a fixed benefit formula through the Social Security Act Amendments of 1972 (P.L. 92-603). The 1972 Act Amendments were intended to provide a final ad hoc boost to Social Security benefits (benefit levels were increased by 20 percent across-the-board), while tying all future benefit growth (beginning in 1975) to increases in the overall price level through a Cost-of-living Adjustment (COLA).[24] The 1972 Act also tied growth in the taxable wage base to future growth in the economy-wide level of wages.[25]

<u>Economic Stagnation and the Recognition of Demographic Challenges</u>

Less than a year after the concept of indexing was introduced, the Social Security Trustees began to recognize how much changing demographics would imperil the sustainability of the program. The 1973 Trustees Report warned that falling fertility rates would lead to a precipitous decline in future worker-to-beneficiary ratios, leading future benefit levels to far outstrip conceivable tax revenue. At the same time, many analysts recognized that the errors in the COLA index formula adopted in 1972 would cause benefits for future retirees to exceed their pre-retirement income.[26]

Congress attempted to address these problems through the passage of three laws. The Social Security Act Amendments of 1977 changed the benefit index to "decouple" initial benefits from increases in the price level,[27] while the 1980 and 1981 Amendments provided stop-gap financing to ensure the program's near-term survival. Ultimately, the period's economic conditions were so unfavorable that the laws could not stem the rapid decline in the Trust Fund's balance, which fell to 0.7 percent of GDP in 1983.[28] Nor did these laws address the looming demographic time bomb posed by the baby boom generation.

---

[22] *Report of the President's Commission on Budget Concepts*, 1967.
[23] Sita Nataraj and John B. Shoven, "Has the Unified Budget Undermined the Federal Government Trust Funds," *U.S. Social Security Administration Retirement Research Consortium*, November 2004.
[24] Kollmann. Under this new procedure, benefits would be increased automatically each January when inflation as measured by the Consumer Price Index (CPI) rose 3 percent or more from the approximate time of the last benefit increase.
[25] Kollmann.
[26] Kollmann.
[27] Under the 1977 Amendments, initial benefits would be computed using a formula that would be indexed to the growth in average wages over the years, instead of prices. This was intended to prevent retirees' benefits from exceeding pre-retirement income by establishing an income "replacement rate." Although viewed as a benefit cut at the time, many economists at the time recognized that this new "wage index" would lead to explosive and unsustainable future benefit growth. CBO estimates that the wage indexing of initial benefits and the overestimation of the consumer price index make up 45 percent of the current Social Security shortfall. "The Future Growth of Social Security: It's Not Just Society's Aging," Congressional Budget Office, July 1, 2003. Also see the Hsiao Commission report, available at: http://www.ssa.gov/history/reports/hsiao/hsiaoIntro.html.
[28] 2005 OASDI Trustees Report.

The "Pre-funding" of 1983

In December of 1981, President Reagan announced the establishment of the National Commission on Social Security Reform, which was chartered to address Social Security's immediate financial crisis, as well as to propose long-term reforms to put Social Security back on a sound financial footing.[29] The Commission needed to find between $150 billion and $200 billion in combined benefit adjustments and tax increases to keep the Trust Fund solvent through the end of the 1980s, and to devise a longer-term strategy to cope with the retirement of the baby boom generation.[30] Virtually all of the Commission's recommendations were enacted into the Social Security Act Amendments of 1983 (P.L. 98-21).

The Commission recommended closing the immediate financing gap by accelerating tax increases scheduled to take place over the course of the decade, and by dramatically increasing payroll taxes on the self-employed.[31] The long-run financing gap was addressed by a gradual increase in the normal retirement age (from 65 to 67) and the imposition of an income tax on the Social Security benefits of wealthier beneficiaries.[32]

Although necessary to avert a re-run of Social Security's financing crises of the late 1970s and early 1980s, the tax rate schedule recommended by the Commission was to result in large and growing surpluses in the system soon thereafter if the economy grew at a rate near the post-War average. To prevent these surpluses from pushing the Trust Fund's balance well above its previous record of 5.4 percent of GDP, significant payroll tax cuts would have been needed beginning in 1993.[33] Instead, the Commission recommended that the higher tax rates be maintained and, beginning in Fiscal Year 1993, that Social Security income and expenditures no longer be included in federal budget totals.[34]

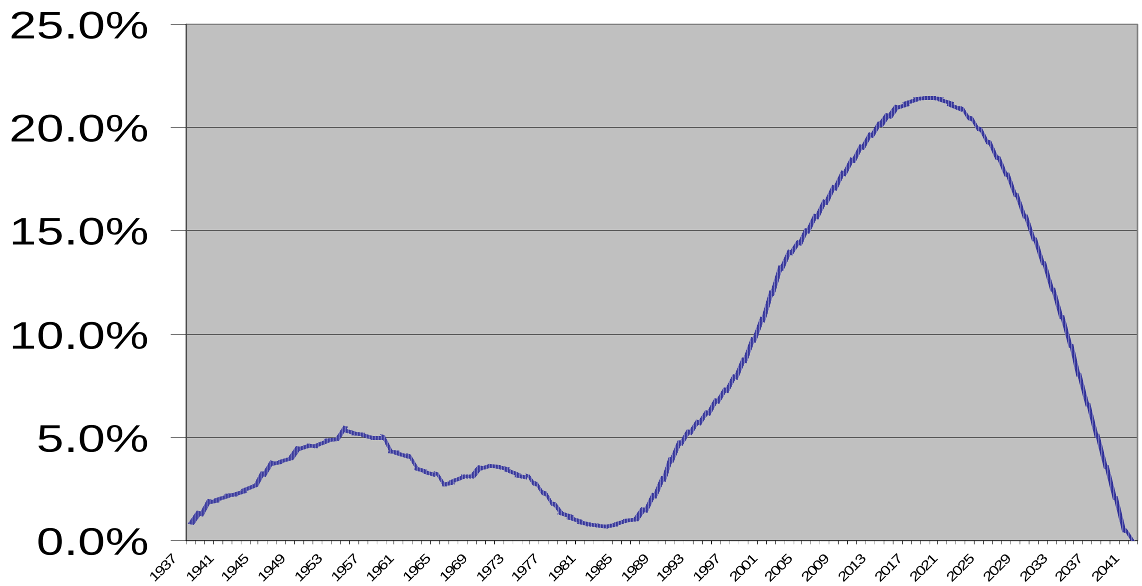
In the years since the 1983 reforms were enacted, many analysts have attributed the decision to leave the tax schedule unchanged to a desire on the part of the Commission to "pre-fund" future benefits. However, according to the Commission's executive director, this approach "just developed; it wasn't planned."[35] Rather, he indicated that the Commission's primary concern was to prevent another financing shortfall in the near term, while ensuring that the tax receipts would be sufficient, on average, to balance over the long run.[36]

---

[29] President Ronald W. Reagan, *Remarks Announcing Establishment of the Commission*, December 16, 1981.
[30] Carmen D. Solomon, "Major Decisions in the House and Senate Chamber on Social Security," CRS Report for Congress 19354985, December 29, 1986.
[31] Social Security Act Amendments of 1983 (P.L. 98-21).
[32] "Beginning in 1984, includes up to one-half of Social Security benefits as taxable income for taxpayers whose adjusted gross income, combined with half their benefits and any tax-exempt interest they may have exceeds $25,000 for a single taxpayer and $32,000 for married taxpayers filing jointly. Benefits received by married taxpayers filing separately are taxable without regard to other income. Appropriates amounts equal to estimated tax liability to the Social Security trust funds." Summary of P.L. 98-21, Social Security Administration.
[33] A payroll tax cut would not have been without precedent. In 1968, Congress reduced the combined OASDI tax rate to 7.6 percent from 7.8 percent and the self-employed payroll tax to 5.8 percent from 5.9 percent.
[34] Solomon.
[35] Robert J. Myers, Oral History Interview, *Social Security Administration History Archives*, January 1995.
[36] According to Myers, several members of the Commission realized that a strategy to balance Social Security revenues and outlays over the long run could distort the budget process: "Let's not have this big fund build up and

Even so, the 1983 Act had the "effect of the baby boomers paying for their own retirement."[37] This meant that, for the first time in Social Security's history, workers would, in essence, partially "pre-fund" their own generation's benefits by paying far higher payroll taxes than required under a pure PAYGO model.[38] These taxes were set so much higher than necessary that, as the graph below depicts, the Trust Fund balance will grow at its peak to a level that is *nearly eight times larger*, as a share of the economy, than its average during the PAYGO era (1940-1983).

Trust Fund Balance[39]
(as a percentage of GDP)



The 1983 Amendments Were Fatally Flawed

The pre-funding "solution" implemented in 1983 was fatally flawed from the outset. The plan generated sufficient surpluses to transform Social Security from a PAYGO system into one that is partially pre-funded, but provided no mechanism to actually save these funds. Since the Social Security Act prohibited the Social Security Trustees from investing in any security other than Treasury bonds,[40] the Trustees were limited to "investing" the large surpluses generated by the 1983 Amendments in assets that represent nothing more than future claims on the General Fund.

then be used up. Let's have more sensible financing," Myers recounts members arguing. "But there was also the attitude of let's not rock the boat now. We've got a consensus, let's take it and run." Myers. Oral History Interview.

[37] Myers. Oral History Interview.

[38] Description of the report of the National Commission on Social Security reform, available at: http://www.ssa.gov/history/repstud.html.

[39] Based on data contained in the 2005 OASDI Trustees Report.

[40] Social Security Act Amendments of 1939, Title II.

As mentioned above, public officials since the late 1930s had expressed concern that such "investments" are economically meaningless.[41] Although this contention has long been debated, it was a matter of little consequence while the Trust Fund balance remained small (as was the case between 1940 and 1983). In fact, past defenders of the Trust Fund's validity attempted to neutralize concerns that its assets were "mere scraps of paper" by pointing to the small amounts of potential General Fund transfers involved, and by suggesting that "there [would] never be any necessity for calling for redemption of a large portion of the fund."[42] Yet, these arguments could hardly apply to the 1983 Amendments, which *were designed specifically to build up a large Trust Fund balance* that would, eventually, be redeemed in full through trillions of dollars in General Fund transfers.

Instead of building up claims on the General Fund, Congress could have elected to amend the Social Security Act to permit direct government investment in private securities, such as corporate bonds, equity shares, or even bank money market accounts; but it wisely rejected this approach because of widespread concern about disrupting markets and socializing the allocation of capital. Since the 1940s, officials have feared that private investment of the Trust Fund would allow the government to control a considerable portion of the private economy, which "would, in effect, result in 'socialism by the backdoor method.'"[43] Thus, government-directed investment was deemed more risky than simply relying on the prudence of Congress. And rightly so.

The Road Not Taken: Congress Failed to Use Surpluses for Deficit Reduction

With no realistic way to structure a government "trust fund" to store Social Security surpluses, the only way the federal government could, in essence, "save" the surpluses, or "pre-fund" benefits, would be to use that money to reduce the unified deficit or retire outstanding Treasury debt. For example, in 1983, the government spent $89.8 billion, or 2.6 percent of GDP, just to pay the interest on the government debt.[44] If Social Security surpluses were used to reduce unified deficits and outstanding debt, many analysts reasoned at the time, then future annual interest payments from the General Fund would be lower, and this "savings" could be directed towards financing Social Security benefits when the program began to run deficits in the future. Although the General Fund would still be responsible for financing future Social Security deficits under this arrangement, the reduction in debt and annual interest payments would make this burden less onerous.

Unfortunately, the 1983 Amendments failed to assure this outcome. Since Social Security surpluses were to be credited to the Trust Fund *whether or not* they were actually used to reduce the deficit or retire outstanding debt, there was no incentive to save. On the contrary, there was every incentive to "double-count" these funds by spending them as soon as they arrived. This double-counting allowed Congress to spend these funds on popular programs,

[41] Robert J. Myers, "Actuarial Aspects of Financing Old-Age and Survivors Insurance," *Social Security Bulletin,* June 1953.
[42] Robert J. Myers.
[43] Robert J. Myers, "Actuarial Aspects of Financing Old-Age and Survivors Insurance," *Social Security Bulletin,* June 1953.
[44] Congressional Budget Office, "Historical Budget Data," January 25, 2002.

while, at the same time, assuring the public that the Trust Fund buildup was going forward as planned.[45]

<u>Trust Fund May Actually Increase Debt More Than if it Did Not Exist</u>

The resulting public confusion over the concept of the Trust Fund as a store of value allowed federal spending to grow unchecked. Recent empirical studies have found that double-counting Social Security surpluses has not only failed to reduce deficits, but it may have actually *increased* the national debt by more than would have been the case had no Trust Fund existed. An analysis authored by Kent Smetters of the Wharton School of Business found "no empirical evidence supporting the claim that Trust Fund assets have reduced the level of debt held by the public. In fact, the evidence suggests just the opposite: Trust Fund assets may have actually increased the level of debt."[46] To explain this counterintuitive conclusion, Smetters writes: "Social Security surpluses represent a potential 'internal' source of government spending that is cheaper politically for politicians to spend relative to 'external' sources of financing such as higher tax rates."[47] Smetters estimates that by competing to spend these cheap "internal" dollars, Congress has increased the on-budget deficit by $1.50 for every $1 of Social Security surplus.[48]

A paper presented at a conference co-sponsored by the Social Security Administration reached a similar conclusion: "The surplus revenues that the trust funds have turned over to the rest of the government have been spent and not saved. As a result, no extra wealth has been accumulated."[49] The authors found that the total federal debt and the publicly held debt would have been *$3 trillion* lower if increases in Trust Fund balances had not been double-counted.[50]

Personal Accounts Provide a Solution to the Trust Fund Problem

The most recent estimates suggest that it will ultimately cost the General Fund $5.4 trillion (in constant 2005 dollars) to reimburse Social Security for all of the surplus funds Congress is scheduled to spend.[51] Instead of continuing on the current path, Congress should embrace *real* pre-funding through the creation of personal retirement accounts – the only way to actually save money for future benefit payments.

---

[45] This incentive to double-count persisted no matter how budgetary rules were adjusted. For example, the Balanced Budget and Emergency Deficit Control Act of 1985 (P.L. 99-177, Gramm-Rudman-Hollings) accelerated the "off-budget" treatment of Social Security to FY1986 from FY1993, but included Social Security in its deficit-reduction targets. The Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) excluded Social Security surpluses from its FY1991 to FY1995 deficit targets, but did not attempt to reach General Fund balance. Although Social Security surpluses were briefly used to retire federal debt in the late 1990s, this period was short-lived, as the "revenue surprise" (the 60-percent increase in federal revenues between 1994 and 2000) that accompanied the bubble economy of the late 1990s soon disappeared.
[46] Smetters.
[47] Smetters.
[48] Smetters.
[49] Sita Nataraj and John Shoven, "Has the Unified Budget Undermined the Federal Government Trust Funds?" NBER Working Paper 10953, April 2005.
[50] Nataraj and Shoven.
[51] 2005 OASDI Trustees Report, Single Year Tables.

Workers Would Own their Personal Accounts

Personal accounts would allow workers to use a portion of their payroll taxes (that currently are slated to be spent on a variety of federal programs) to invest in a conservative range of regulated investment funds. The assets in these accounts would become the property of the worker as is currently the case for money invested through 401(K) plans and Individual Retirement Accounts (IRAs). While Congress habitually diverts revenues intended for the Trust Fund to increase current spending, the government has never been so bold as to seize the assets held in 401(k)s or IRAs, nor would such action be constitutional.[52]

Critics of personal accounts often protest that personal accounts would "take money out of Social Security," by "carving out" payroll tax revenue intended for the Trust Fund. Although these funds are intended to be saved, history teaches us that in practice they subsidize spending in the rest of government. Given the fact that surplus payroll tax revenues are spent on unrelated programs as soon as they arrive, critics of personal accounts are in the awkward position of explaining how saving Social Security taxes to pre-fund Social Security benefits is "taking money out of the system," but diverting Social Security taxes to the thousands of government programs they fund is somehow "protecting the system."

Forced to confront reality, critics often then point to short-lived budget surpluses around the turn of the century as evidence that the current arrangement can work if the General Fund is managed prudently. Indeed, the General Fund was in surplus in both 1999 and 2000, and its deficit was smaller than the Social Security surplus in 1998 and 2001.[53]

Yet, this experience provides a strong rebuttal to the notion that Congress can save the Social Security surplus. The Balanced Budget Act of 1997 (P.L. 105-34) sought to balance the unified budget, not the General Fund.[54] And even this less ambitious goal was to be phased in over five years, with the first unified surplus to be recorded in 2002. It was only because of the "revenue surprise" of the late 1990s that the General Fund ever reached balance.[55] Moreover, once the General Fund began to run a surplus, Congress immediately eschewed the spending discipline necessary to maintain it: discretionary spending increased by 17.5 percent between FY98 and FY01.[56]

With no clearly delineated ownership right to the Social Security surplus, there is no check on the government's propensity to spend those funds. History has shown that no matter what accounting devices or "lockboxes" are constructed, the money will be spent if no ownership right is assigned to it. Personal accounts represent a better way of storing money for the future. If Congress tried to tap this money, it could no longer rely on budget accounting.[57]

---

[52] As the 5th Amendment states: "No person shall… be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."
[53] "Historical Budget Data," Congressional Budget Office, January 25, 2005.
[54] "The Economic and Budget Outlook: An Update," Congressional Budget Office, September 1997.
[55] "Historical Budget Data," Congressional Budget Office, January 25, 2005.
[56] "Historical Budget Data," Congressional Budget Office, January 25, 2005.
[57] Kent Smetters, "The Myth of the 'Free Lunch' in Social Security," *Financial Times*, September 9, 2004.

Temporary Borrowing Necessary to Create Accounts

The chief concern expressed by opponents of personal accounts is that they will require vast amounts of new borrowing. However, the bulk of this borrowing will not be required to create accounts, but to fund government outlays currently financed by Social Security surpluses. Since personal accounts would end the disingenuous practice of double-counting, each dollar saved to pre-fund future Social Security benefits would no longer be available for Congress to spend.

According to the 2005 Trustees Report, Social Security payroll taxes will exceed benefits by $854 billion between 2006 and 2016.[58] By comparison, the investment in personal accounts proposed by the President is estimated to equal $754 billion over the next 10 years.[59] Thus, in the near-term, the Social Security surplus is of a sufficient size to be used to pre-fund future benefits in personal accounts. Any short-term increase in debt following the introduction of accounts would be used to cover excess government spending that had heretofore depended on Social Security surpluses. In this way, personal accounts do not "create" new deficits; rather, they "reveal" deficits that already exist. It is likely that federal spending will decline, relative to the baseline, once these surpluses are no longer available to spend.

However, personal accounts will move up the date that Social Security will begin to run cash deficits and need to rely on its Trust Fund to pay benefits. This will likely require the issuance of new debt to fund personal accounts. However, it is not at all clear that this borrowing will have the harmful economic effects often associated with deficits. Whereas federal borrowing to cover current spending soaks up finite private savings, which can raise interest rates and "crowd out" private sector capital investment, when it comes to borrowing to create personal accounts, this criticism should not apply.[60] Since the borrowed funds would be immediately invested in bonds and broadly diversified stock funds, there would be no decrease in national savings or "crowding out."[61] And since individuals who elect to open an account would agree to forego future benefits on a dollar-for-dollar basis (compounded at the federal borrowing rate), the long-run cost of personal accounts is minimal.[62]

Conclusion

Social Security was financed on a PAYGO basis from its inception until the reforms of 1983. During that time, the Trust Fund balance was typically small and of no direct significance to policymaking. The 1983 Amendments intended to move the system from PAYGO to one in which workers would partially pre-fund their own generation's retirement benefits, but it failed in its implementation because Social Security surpluses were not saved.

---

[58] 2005 OASDI Trustees Report, Single year tables.

[59] "Strengthening Social Security for the 21st Century," The White House, February 2005.

[60] William G. Gale and Peter R. Orzag, "Budget Deficits, National Saving, and Interest Rates," September 2004.

[61] N. GREGORY MANKIW and PHILLIP SWAGEL, "Free Advice for Democrats," Wall Street Journal, March 3, 2005.

[62] Although the offset rate is calculated to achieve fiscal neutrality, there would be some small "leakage" in the form of people inheriting accounts from people who have no retirement benefits to offset. An example of this dynamic would be when someone dies at the age of 60 and leaves his account to his adult children.

History teaches that this money will not be saved if it continues to be part of the government's operating cash pool. Congress should end this practice and establish a clear ownership right to Social Security surpluses by creating personal retirement accounts as a part of Social Security modernization this year. Continuing down the current path not only will fail to provide a solution to Social Security, but it will likely result in even greater deficit spending.